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Moody's Changes Course on Ratings Scale

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By Dakin Campbell

Moody's Investors Service yesterday altered its plan of offering both municipal and global scale ratings for municipal bonds and instead proposed migrating its municipal scale so that it is in line with its other global ratings.

The agency also extended the public comment period on the change until June 30. The comment period was first announced in mid-March. Also, Moody's will suspend the assignment of all global scale ratings until the comment period ends.

During the original period, Moody's received feedback from almost 200 market participants. The majority of respondents said the maintenance of two scales, as Moody's had originally intended, would be too confusing, difficult to track, and lead to questions about which rating is "the" rating, Moody's said in the report yesterday.

"If you remember, our original March [request for comment] talked about assigning global ratings in addition to the muni ratings, but the overwhelming feedback from the market is that one rating scale is significantly preferable," Gail Sussman, group managing director for U. S. public finance. "Their comments very clearly revealed a strong preference for a single rating scale."

In the March report, Moody's said it would keep the municipal scale, but would clarify the conversion table used to map munis to global ratings.

Under the new proposal, Moody's said it will migrate the municipal ratings in such a way that it will give a reasonable differentiation at the higher rating levels, Sussman said. This will be done by considering similar qualitative factors as those used in rating corporate credits including transition risk, financial management, governance, and default risk, and not simply expected loss, which is captured in other global rating scales, Moody's said in the release.

The ratings migration will not require municipal issuers to change the way they calculate their financial statements, Sussman said.

Moody's said the comment period was extended to allow market participants to review the new proposal. Written feedback can be e-mailed to the Moody's credit policy team or by contacting the public finance managers directly, according to the ratings agency.

A number of market participants reacted to the new proposal, including Rep. Barney Frank, D-Mass., chairman of the House Financial Services Committee, who has been highly critical of the ratings process and has planned legislation mandating a single scale.

Frank said Moody's decision makes sense in light of historic default rates, determined in a study of the years 1970 to 2006, for general obligation bonds that are far lower than corporate bonds.

"This is a long overdue acknowledgement that overwhelmingly safe municipal bonds do not deserve the punitive treatment they have received under a separate rating scale," Frank said in a statement. "It is time for municipal bond issuers to receive proper credit for the virtual lack of any loss on general obligation bonds."

California Treasurer Bill Lockyer, who led an effort to overhaul the current system used by the rating agencies, said the decision is a step toward fairness for taxpayers and municipal issuers.

Lockyer said he would like Moody's to place its rating emphasis on the risk of default, and while he doesn't oppose the other factors like transitional risk, governance, or disclosure quality he believes they should show a clear relationship to any risk that investors would not get paid.

"I commend Moody's for taking this step, and for its thoughtful, reasoned response to the concerns of municipal bond issuers," Lockyer said. "We look forward to providing comments on the proposal."

The ratings migration is likely to most affect cities, counties, and school districts, and, to a lesser extent, hospitals and long term care facilities, said Richard Larkin, head of research at Herbert J. Sims & Co.

Contrary to Lockyer's view, Larkin said the migration of credits may not, in fact, change state GO bond pricing levels all that much. The ratings migration is likely to affect liquidity levels, as more credits become eligible for money market funds with strict ratings criteria.

"It is uncertain how these new ratings will affect municipal bond pricing," Larkin wrote. "State debt pricing may see very little differential, since state debt has long been eligible as investments for these funds."

The market to protect against default also shows a difference. Natural triple-A rated Maryland GOs for a 10-year credit default swap have a 16-22 bid-offer quote, while California, rated A1 by Moody's and A-plus by both Standard & Poor's and Fitch Ratings, has a 64-70 bid-offer quotes, according to Lehman Brothers.